DEPARTMENT OF PUBLIC SERVICE REGULATION
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MONTANA

Memorandum

To: Commissioners October 6, 2006
Cc: Martin, Will, Kate, Robin
From: Mike
Re: NWE QF Avoided Cost Dockets: D2003.7.86, D2004.6.96, and D2003.6.103

IN THE MATTER OF NORTHWESTERN ENERGY, Application for Approval of 2003 Avoided Cost Compliance Filing -- Schedules QFLT-1 and STPP-1	)))	UTILITY DIVISION DOCKET NO. D2003.7.86
IN THE MATTER OF NORTHWESTERN ENERGY, Application for Approval of 2004 Avoided Cost Compliance Filing -- Schedules QFLT-1 and STPP-1	)))	UTILITY DIVISION DOCKET NO. D2004.6.96
IN THE MATTER OF NORTHWESTERN ENERGY, Application for Approval of 2005 Avoided Cost Compliance Filing -- Schedules QFLT-1 and STPP-1	)))	UTILITY DIVISION DOCKET NO. D2005.6.103

I. Introduction

Due to the volume and the nature of material in these consolidated QF (qualifying facility) avoided cost dockets including the extensive briefing that was not concluded until mid-September we bifurcated the issues, for work session purposes, into two groups: Colstrip Energy Limited Partnership (CELP) related and other QF rate issues. This should facilitate decision making as there is minimal overlap between the CELP issues and the other QF rate issues. I address the CELP issues in this memo. In a subsequent memo we address all other QF rate issues. As for the CELP issues, I first review and summarize the issues that were raised in testimony. I next review and summarize the issues that were discussed in the parties' briefs. I plan to review the attached material during the October 12th work session.[1] A final section consolidates the issues for purposes of discussion and recommendations. If you have need for other material, please let me know.

II. Testimony: A Summary of Issues

The relevant background material for a work session on the CELP issues includes prefiled testimony, the hearing transcript, discovery, late-filed exhibits and the briefs (as of the date of this Memo I had not had an opportunity to read the entire transcript). As for the prefiled testimony, our June 6, 2006 Fact Sheet provides a summary of the six pieces of testimony that are directly related to the CELP issues. Therefore, the relevant parts of the Fact Sheet include the following:

(1) Introduction and Background, (pp. 1-3);
(2) NWE's additional issues testimony of Mark Stauffer, (pp. 11-12);
(3) CELP's direct testimony of Owen Orndorff, (pp. 16-21);
(4) CELP's direct testimony of Richard Lauckhart, (pp. 34-39);
(5) NWE's rebuttal testimony of Mark Stauffer, (pp. 42-47);
(6) CELP's surrebuttal testimony of Richard Lauckhart, (pp. 49-52) and,
(7) NWE's surrebuttal testimony of Mark Stauffer, (pp. 52-56).

In the following, I distill from the Fact Sheet an even shorter summary of the issues contained in the above six pieces of testimony. Following each summary of testimony, I list the issues that were raised and that appear to require PSC decisions (even though an issue has become moot, a finding of fact may still be necessary). I provide these summaries to enable decision making. These summaries should also aid in understanding the relevance of the issues that the briefs discuss. Because the PSC has only granted interim approval of NWE's qualifying facility long term (QFLT) and short term power purchase (STPP) rates in each of the three dockets the PSC must finalize those interim decisions.

[1] Attachments include: 1) Finding of Fact 34, Order 4865; 2) parts of orders 5017 and 5017a, 3) MPC's 1983 and 1984 QFLT compliance filings and 4) the 1st Amendment to the CELP/MPC contract.

1. NWE filed the additional issues testimony Mark Stauffer (item (2) above). Stauffer's testimony responds to the PSC's additional issue that regards whether, and how, CELP's contract was amended to include any security and liquidated damage provisions. Stauffer testified that NWE has no contract related issues in this docket.

ISSUES THAT REQUIRE DECISIONS: The PSC must distinguish those issues over which it has jurisdiction from those over which it does not have jurisdiction. Such consideration may involve a general conclusion with later application to specific issues. (as issues reoccur in the course of reviewing testimony they will be consolidated).

2. CELP filed the direct testimony of Owen Orndorff (item (3) above). Orndorff disagreed with the PSC for having raised the additional contract issue. His disagreement stems from the PSC's prior conclusion that it has no jurisdiction over such (contract) matters.[2] He testified that the 1st Amendment between CELP and MPC (attached) freed CELP of any security obligation and it freed NWE of any refund obligation. NWE would have a $57 million obligation if it terminated the agreement (a concern apparently related to NWE's bankruptcy). He also testified that CELP must now be made whole for the prior years' underpayments.[3] Based on his disagreement with MPC's out-of-market cost estimate he testified that the actual market prices that were used should be updated (1998-2004) to see if the QF contracts are out of market and so that pricing will reflect the replacement cost of long-term resources. He adds that the most appropriate basis of market prices is the Mid-C plus BPA wheeling and line loses. Finally, he recommends that the QF contracts be "promptly assumed."

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[2] In an October 17, 1997 Final Order (D97.7.127 et al.,) the PSC declined jurisdiction over matters regarding the curtailment of power purchased from QFs. The PSC concluded that it generally does not have jurisdiction to decide disputes between utilities and QFs over the terms and conditions of executed contracts.

[3] CELP adds that "…any action to void the amendment will result in significant additional payments to CELP to recover previous underpayments…" CELP further added: "Assuming AEM/CELP does perform for the contract term, MPC/NWE has an obligation to refund the AEM/CELP security funds in the later years." (pp. 4, 9, direct)

ISSUES THAT REQUIRE DECISIONS: The following issues appear to require decisions: (1) the PSC's jurisdiction over the contract issue(s) that CELP raised; (2) whether to order an update for select years (1998-2004) of NWE's out-of-market cost estimates; (3) the issue of "promptly assuming" the QF contracts (again, there may be issues that, although moot, require a PSC response); (4) the appropriate basis of market prices to determine the replacement cost of long-term resources (e.g., adjusted Mid-C) and (5) whether, and how to respond, to CELP's position that it must be made whole for the prior years' under payments (the $57 million obligation NWE would have if the contract with CELP was terminated).

3. In his January 24, 2006 testimony (item (4) above), CELP's witness Richard Lauckhart limited his avoided cost concerns to the 2005-06 contract year. The issues that he then raised include: NWE's alleged failure to use the incremental cost of capital (ICC) with tax effects, escalators that involves indexes and coal costs. He recommends a 10.65% cost of capital (13.15% on equity and 8.15% for debt) and an unweighted capital structure that is consistent with what Southern California Edison (SCE) pays to finance new projects. He criticized NWE for failing to include tax effects in its cost of capital (when included his after-tax cost of capital rises from 13.15% to 21.37%). He recommends implementing his proposals in NWE's "next rate filing." He asserts that other than for interims no approved rates can be adjusted. He recommends annual updates to three measures of changed avoided costs (the GNP-IPD, the Unit Labor Cost (ULC) and the non-residential fixed investment used to escalate capital (construction and O&M costs). He adds that the ULC escalator needs to be corrected. He testified that coal costs should include severance taxes. Lauckhart also testified that ratepayers are protected from the impact of higher QF avoided cost rates.

ISSUES THAT REQUIRE DECISIONS: Issues that appear to require decisions include: (1) the contract year in which his proposals, if adopted, would be implemented (e.g., the 2005-06 contract year, "the next rate filing" etc.,); (2) whether NWE's cost of capital should be based on SCE's costs); (3) whether tax effects are included; (4) the ULC escalation (index) correction issue; (5) the inclusion of coal severance taxes, (6) whether there are ratepayer impacts if certain QF rates are changed and (7) annual updates to the three measures of changed avoided costs. I would also illuminate that part of Lauckhart testimony wherein he asserts that the PSC may not now adjust other than interim rates.

4. On February 28, 2006 NWE filed the rebuttal testimony (item (5) above) of its witness Mark Stauffer. Stauffer rebuts Lauckhart's testimony on issues that include the cost of capital, coal severance taxes and an alleged error with his ULC estimate. He admits to an error in computing the ULC. He denied any error involving coal severance taxes, holding that they are included in coal costs. The balance of his testimony addressed issues surrounding the cost of capital.

Stauffer admits that NWE did not use an incremental cost of capital (ICC) estimate. Instead, he used the allowed rate of return (ARR) from PSC Order 6271(c) to compute annual carrying charges (ACCs) for both C 3 & 4 and for a peaking plant. He testified that FOF 34 (Order 4865) is irrelevant. In an apparent reference to Lauckhart's ICC proposal, he holds that Lauckhart has raised a new and significant issue. If CELP's ICC proposal is adopted, then all inputs associated with the variable (e.g., current taxes and insurance rates) should be updated. He asserts that values for the variables (depreciation, taxes, return on equity, debt, insurance and property taxes) in the levelized fixed charge factors (LFCF) have been held constant since 1988. He adds that CELP's 13.15% cost of equity is speculative and that the currently approved 10.75% should be used. If the PSC approves of CELP's 13.15% cost of equity in NWE's next rate case, NWE will use the same to compute CELP's rates. He also asserts that it is improper, from an accounting perspective, to use the ICC to compute the annual carrying charge (ACC) and restates that NWE uses the ARR in the ACC. As for taxes, he testified that because incremental taxes were included in the original LFCF, it would be "double counting" to gross up the ICC now. He recommends rejecting CELP's attempt to increase its rate (in an apparent reference to the ICC). He asserts that NWE does not have a fresh cost of equity for an ICC estimate but notes that NWE can update the ARR for debt costs.

<u>ISSUES THAT REQUIRE DECISIONS</u>: First, as for the non-ICC related issues, the coal severance tax and the ULC, will require PSC findings. As for the issues surrounding the ICC, the following will require decisions: (1) whether to continue the practice (since 1988) of using the same LFCFs or, in the alternative, to order new LFCFs with all components updated (ICC, depreciation, taxes etc.,); (2) whether to continue the practice, apparently implemented in 2001, of using the ARR to compute the ACC or, in the alternative, to order the use of an ICC in the ACC; (3) in what venue to estimate the appropriate ICC; and (4) in what year to begin implementing any changes (options include the 16th year of the 1st Amendment corresponding to the 2004/2005 etc.,).

5. In his March 10, 2006 surrebuttal testimony (item (6) above), CELP's witness Richard Lauckhart testified that Stauffer asked, in rebuttal and for the first time, that the PSC adopt new and different QF rate calculation methodologies in an effort to harm CELP. The alleged harm stems from changes including: (1) that because NWE is proposing a change to the escalation formula,[4] and is a contractual change, it must be negotiated with CELP (he does not further explain what "escalation" is referenced except to cite the 1st Amendment); (2) use of the embedded cost of capital in violation of PSC orders; and (3) violation of the CELP contract. In this regard, Lauckhart asserts that the only approved method is to use the ICC, with annual updates. He also asserts that PSC Order 4865 obliges NWE to continue making annual rate updates. His own proposed value for the ICC is consistent with this methodology. He disputes Stauffer's view that the proper venue to determine the ICC is an involved PSC hearing. He admits that the embedded cost of capital is determined in a rate case proceeding.

<u>ISSUES THAT REQUIRE DECISIONS</u>: The first alleged harm, involving escalation appears an ICC related issue involving the 1st Amendment to the CELP/MPE contract. If it is CELP's intent to link this "escalation" concern to the change in the cost of capital, then the following issues emerge: (1) whether it is a change in methodology to

[4] Lauckhart understands Stauffer's testimony to assert that the ICC is used when the rate was originally computed and is not meant to be used with annual adjustments. He

not use the ICC (to use the ARR in its stead); (2) when (frequency) and where (venue) to determine the ICC (the embedded ICC is determined in a rate case) and (3) the relevance of the PSC's order 4865 as a basis for requiring NWE to compute annually CELP's rates and, for that matter, QFLT rates generally.

6. NWE's witness Mark Stauffer May 4, 2006 surrebuttal (item (7) above), rebuts CELP's surrebuttal. Stauffer identifies the following issues: (1) whether to use the ICC or the ARR with the annual escalation of rates and whether to use 8.143% as the ICC for each of the three years of QFLT rates; (2) whether to account for "tax effects" a second time; (3) the measure of inflation that is used to escalate rate variables; (4) whether the first three (above) issues are contract issues or rate calculation issues; and (5) the relevancy of the prior year's rates in the calculation of year 16 rates when the ratio approach is first integrated into CELP's rate calculation (2004/2005 contract year).

As for the first issue, he admits that in 2001 MPC began using the ARR. As MPC divested itself of generation, it did not have a generation-specific ICC. He also considers the use of the ICC versus the ARR to be an input substitution change and not a change in methodology. NWE agrees to use the ICC if it is directed to do so.

As for the second issue, he asserts that "tax effects" should not be an issue given that they were in the initial rates and because NWE escalates the tax adjusted cost of capital. He estimates that the impact of double counting taxes amounts to $15.8 million per year adding that there may be indirect ratepayer impacts. He also rebuts Lauckhart's position that CELP did not raise this issue as it had not emerged until year 16. Stauffer holds that CELP could have raised the issue when Orndorff testified or in any of the first two QF dockets.

As for the third issue, he testifies that Lauckhart does not understand how rates are escalated adding that NWE is under no obligation to negotiate these matters with CELP. He identified three occasions since 1989 when the PSC has approved of revisions to escalation indices.

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testified that the only method that is allowed by MTPSC order, or the CELP contract, is the overall ICC, including tax effect, not the embedded cost of capital (p. 3).

As for the fourth issue, he disagrees that "contract requirements" have any relevance in this proceeding, as they are rightfully before a court and not the MTPSC.

As for the fifth issue, Stauffer testifies that 2004-2005 is not the first relevant contract year as the year 16 rates depend on year 15 rates. While year 2003-2004 rates are the first rates that directly impact year 16 rates in reality all QFLT rate filings are relevant to CELP's present rates, a result that stems from the unique use of ratios in CELP's 1st Amendment and that begins in year 16. As for the ratio approach used to compute CELP's rate increases, which began in year 16, he adds that the numerator and the denominator in the ratio must be calculated using the same method.

ISSUES THAT REQUIRE DECISIONS: The issues to decide appear to include: (1) use of an ICC versus an ARR; (2) use of NWE's ICC estimate of 8.143%; (3) adjusting the ICC for "tax effects" ; (4) when CELP had its first opportunity to address issues such as tax effects; (5) rate escalation; (6) PSC's jurisdiction over changes in, and the, rate (method) calculations; (7) whether changes are simple input issues or whether they involve changes in methodology that must be negotiated with CELP; (8) implementation of the ratio approach and whether the implication of current rates being dependent on all prior QFLT rates and (9) which of the above are contract and, or, rate issues.

III. Briefs: A Summary of Issues[5]

The following reviews the issues that were discussed in the parties' briefs. For each of the below listed (13) issues, the review of the parties' positions (from their briefs) is chronological, beginning with the opening (August 1st) briefs and concluding with NWE's September 13th reply brief. I review the briefs as they often times provide a good summary of the record evidence. On occasions, however, a party may use briefing to raise new issues.

[5] The indicated briefing dates are the receipt dates the PSC stamps on each brief.

1. Update Rates for Years 1 to 16:

Per the 1st Amendment to the contract, NWE (f/k/a MPC) must compute the escalating energy rate using certain variables from the annual rate filing required in order Nos. 4865 and 5017; thus, the variables must be updated annually from year 1 to year 16 when the formula would first be applied (CELP 8/1/06 Opening Brief on Interim Rates, p. 2).

CELP also states that the 1st Amendment requires NWE to compute, with annual updates from year 1 to year 16 when the "formula would first be applied," escalating energy and capacity rates using "certain variables," after which variables as filed are entered into a formula (CELP 8/31/06 Response to NWE's Post-Hearing Brief, p. 2).

2. Retroactively Adjustment to Contract years 2004/05 and 2005/06 Rates:

CELP filed on February 23, 2006, a conditional motion to retroactively adjust interim rates filed by NWE for contract years 2004/05 and 2005/06. Because NWE improperly implemented D83.1.2, according to CELP, by using embedded capital costs without tax effects, NWE owes CELP $27,564,102 (see Lauckhart's Surrebuttal Testimony) for these two years (CELP 8/1/06 Opening Brief on Interim Rates, pp. 3-6).

NWE recommends that the PSC disregard CELP's conditional motion on the grounds that the record does not support CELP's calculation of NWE's ICC because the calculation is unreasonable and unrealistic (NWE's 8/2/06 Initial Post Hearing Brief on its Motion for Amended Compliance Filings Interim Rates, p. 9).

CELP's 2/23/06 Conditional Motion for interim rate relief should be granted[6] (CELP 8/15/06 Reply Brief on Interim Rates, p. 11).

CELP restates its position (in its 2/23/06 motion for a retroactive adjustment) alleging that NWE improperly implemented D83.1.2 by using an embedded capital cost and by not considering tax effects and again asserts that NWE owes CELP $27,564,102 (CELP 8/31/06 Response to NWE's Post-Hearing Brief, p. 3).

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[6] CELP made this a Conditional Motion based on NWE's September 2005 motion to amend interim rates, what CELP labels a retroactive adjustment. CELP believes that NWE's motion is a "breach" of CELP's contract (CELP's 2/23/06 conditional motion, p. 2).

3. Unilateral Dropping of Tax Effects:

Tax Effects were dropped in 1993, (CELP 8/1/06 Opening Brief on Interim Rates, p.4); MPC unilaterally made this change and without notice (CELP 8/15/06, Reply Brief, p. 2).

NWE strongly opposed CELP’s position and intends to address this in its case in chief (NWE’s 8/16/06 Response to CELP’s Opening Brief on Interim Rates, p. 3).

CELP raises this issue again in its response brief. CELP also adds that because the principal on loans can only be repaid with after-tax dollars the cost of capital requires after tax returns (CELP 8/31/06 Response to NWE’s Post-Hearing Brief, pp. 4, 12, 22).

In its reply comments, NWE rebuts CELP on the matter of whether NWE dropped tax effects. See issue number five below for a continuation of this summary (NWE 9/13/06 Reply Brief to CELP’s Response Brief, pp. 8-12).

4. Unilateral Dropping of ICC:

Incremental cost of capital (ICC) was dropped in 2001 and without the PSC’s consent (CELP 8/1/06 Opening Brief on Interim Rates, p. 4).

PSC should deny CELP’s ICC rate adjustment but admits ICC could be used (NWE 8/2/06 Initial Brief on Motion For Amended Filings Interim Rates, p. 9).

MPC unilaterally made the change without notice (CELP 8/15/06, Reply Brief on Interim Rates, p. 2).

NWE strongly opposes CELP and will address this in its case in chief, (NWE 8/16/06 Response to CELP’s Opening Brief on Interim Rates, p. 3).

NWE asserts that CELP has never understood that the directive in the PSC’s orders for an “initial” and subsequent annual compliance updates are not the same thing (NWE 8/18/06 Post Hearing Brief, p. 8).

CELP raises this issue again in its response brief (CELP 8/31/06 Response to NWE’s Post-Hearing Brief, pp. 4, 12).

5. Double Counting of Taxes:

There is no double counting of tax impacts if rates are properly computed (CELP 8/1/06 Opening Brief on Interim Rates, p. 7).

In its reply comments, NWE rebuts CELP on the matter of whether NWE has dropped the effect of taxes. NWE finds that CELP's "missed tax" argument has no basis in fact. NWE quotes an exchange with CELP's witness Lauckhart during the hearing to buttress its position that tax effects are at present taken into account. NWE adds that CELP's position, that taxes had been excluded since 1993, is a newly raised argument that first appeared in the hearing. Whereas a document (filed in response to CELP -042(a)) excluded any mention of marginal tax rates, the effective levelized fixed charge rates for the 1993-94 contract year are identical to that used in 1992-1993, when there was an explicit accounting of the marginal tax rate. Further, it is evident from NWE's response to CELP -042(a), that NWE included taxes in all years. NWE next comments that any necessary correction of tax effects should not be limited to just one year such as CELP recommends. Thus, NWE concludes there is no need for "double taxing" in this case (NWE's 9/13/06 Reply Brief to CELP's Response Brief, pp. 8-12).

6. Bankruptcy Court:

Bankruptcy court jurisdiction has ceased (CELP 8/1/06 Opening Brief on Interim Rates, p.12).

Bankruptcy court jurisdiction is over security and excess power rate (NWE 8/2/06 Initial Brief on Interim Rates, pp. 2-4).

7. NWE's September 2005 Amendment:

NWE explains the consequences of not having received approval of its September 28, 2005 amendment to interim, a request that should have been handled in the same manner as the interim, adding that §69-3-304 M.C.A. does not prevent the PSC from making any adjustment prior to final ratemaking (NWE 8/2/06 Initial Brief on Motion for Amended Compliance Filings Interim Rates, pp. 1, 6, 8 and 10).

NWE asserts that CELP never challenged NWE's filing to amend interim rates (NWE 8/16/06 Response to CELP Opening Brief on Interim Rates, p.2).

CELP argues that the correction should not be allowed as implicit in any approval is a decision to allow NWE to use embedded costs of capital without tax effects. In the alternative, CELP asserts that its ICC estimate, which correctly used 4 quarters of data, should be approved. CELP adds that NWE's approved interim rates and the "proposed adjustment" fail to satisfy two tests, an apparent reference to whether they are in accord with D83.1.2 and verified by MPC's June 1984 filing as evident from NWE's Late Filed Exhibit 2 (CELP 8/31/06 Response to NWE's Post-Hearing Brief, pp. 4-5 and p. 9).

8. Unknown Basis of 1st Amendment Rates:

CELP asserts to have not known, until NWE filed its LFE # 2, how MPC computed the 1988 rates that are in the 1st Amendment (CELP 8/15/06, Reply Brief on Interim Rates, pp. 2, 10).

CELP recites part of a March 21, 1988 letter from MPC to Owen Orndorff wherein MPC explains the partially levelized rate. This is in apparent furtherance of the 1st Amendment to which CELP agreed and upon which CELP states to be assured of "refunds of security starting in Contract Year 16."[7] CELP adds that as discussed in the March 1988 MPC letter, CELP's 1st Amendment incorporating D83.1.2 annual updates for escalating energy and capacity clearly substantiates its reliance on the recovery of withheld payments during the first 15 years was a reasonable expectation (CELP 8/31/06 Response to NWE's Post-Hearing Brief, pp. 10-11).

In its reply, NWE asserts that MPC worked with CELP to obtain financing by negotiating rates. As the rates were agreed to between the parties, they were not "fixed" by MPC. As CELP exercised its business judgment when it consciously agreed to the 1st Amendment and the PSC should decline to accept CELP's cure. Thus, NWE concludes, CELP's attempt to "paint these rates" as harmful should be denied (NWE 9/13/06 Reply Brief to CELP's Response Brief, pp. 3-4).

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[7] The 1st Amendment states that for the term of the agreement that there are no "refund obligations by MPC."

9. Escalation Adjustment for Shorted Rates:

CELP asserts that a project commencing operation in 1989 should have received the associated rates. Because MPC ignored six years of escalation (1984-1989), CELP was "shorted" for the predetermined rates during the first 15 contract years; whereas CELP is entitled (per the 1st Amendment) to whatever the annual rates are in 2004/05 and 2005/06, regardless of whether MPC selected the first year 1984 tariffed rates instead of first year 1989 rates for payments to CELP for years 1-15, the escalating energy and capacity rates beginning in year 16 must take into consideration for the six years during which MPC shorted CELP. CELP calls this an "escalation adjustment" that "catches up" for MPC's understatements of CELP's rates (CELP 8/15/06, Reply Brief, pp. 3, 9, 10).

CELP re-states that NWE must recognize under D83.1.2 an escalation adjustment for five (5) years which "catches up" for MPC's understatement of CELP's rates in 1989 based on 1984 rates and that corrects errors made by NWE and MPC in the first 15 years starting in 1993 (CELP 8/31/06 Response to NWE's Post-Hearing Brief, pp. 6-7).

CELP explains that NWE would like the PSC to ignore that CELP's first year contract rate was $.02222/kwh instead of the tariffed compliance filing rate of $.03751/kwh. In contrast, CELP asserts that NWE's Late-Filed Exhibit 2 shows the appropriate energy rate to be $.02891 in 1990. CELP calculated the "underpayment cost to CELP of $57,000,000" (CELP 8/31/06 Response to NWE's Post-Hearing Brief, pp. 7-9).

NWE characterizes CELP's comparison as suggesting that because CELP's delivery did not begin until 1989 that CELP is pursuing a "catch up" in their contract. NWE emphasized that the contract year is not identified by the "base year" (column 2, LFE # 2) (NWE 9/13/06 Reply Brief to CELP's Response Brief, pp. 5-6).

10. CELP's Incremental Cost of Capital (ICC) Estimate:

CELP's witness Lauckhart's ICC estimate, which is based on Southern California Edison's (SCE's) ICC, should be used. CELP holds that SCE's and NWE's businesses are significantly similar. CELP does not believe the ICC evidence that NWE provided is credible and adds that NWE's witness Stauffer had no familiarity with two "financings" that were apparently mentioned to discredit CELP's estimates (CELP 8/15/06, Reply Brief on Interim Rates, pp. 6-8).

NWE asserts that because CELP's expert wants to use the "new calculated number" in only one year (the numerator) that the proposal is not consistent with using his corrected numbers in all years[8] (the numerator and the denominator) (NWE 8/18/06 Post-Hearing Brief, p. 4).

CELP's ICC estimate, that correctly used 4 quarters of data, should be approved. In addition, the magnitude of the required correction is the same whether it is recalculated each year since 1992 (when MPC first removed tax effects) or if the correction was made in one adjustment now. Without knowing what MPC's 1984 compliance filing would predict for escalating rates, CELP adds that its witness' estimate of rates for contract years 16 and 17 are surprisingly close.[9] CELP further adds that the results lend support to its February 23, 2006 motion for interim rate relief. CELP asserts that the only witness NWE sponsored had no clue about the basis of cost of capital that was used to dispute CELP's ICC estimate (CELP 8/31/06 Response to NWE's Post-Hearing Brief, pp. 7-9, 17-18).

NWE explains that the comparison CELP has made, that purports to demonstrate how close CELP's proposed rates are to rates in NWE's Late Filed Exhibit # 2, is logically flawed. It is flawed because CELP made a comparison of contract year 21 rates to rates for 2004. NWE characterizes CELP's comparison as suggesting that because

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[8] The equation in the 1st Amendment defines:

$ER_n = [ER_{n-1}]\ \mathbf{x}\ [(ESC\ ER_n - PESC\ ER_n)\ /\ (ESC\ ER_{n-1} - PESC\ ER_{n-1})]$ where,

ER_n, $ESC\ ER_n$, $PESC\ ER_n$ are respectively the energy rate, the escalating energy rate and the escalating portion of the partially levelized energy rate (all for contract year "n"). The 1st Amendment provides definitions for all other energy and capacity variables.

[9] CELP states that MPC's June 18, 1984 Compliance filing featured an escalating energy and capacity rate for, for example 2004, of \$.06454/kwh and \$162.44/kw/yr, respectively. In the same year, CELP's estimate is \$.070105/kwh and \$115.858/kw, respectively. The data CELP reports here, however, appears to derive from NWE's July 28, 2006 Late Filed Exhibit 2, p. 4/8, wherein for contract year 21 (2004) there appears a "partially levelized" energy and capacity payment that matches \$.06454/kwh and \$162.44/kw/yr. The rates for the first 15 years also appear to match the rates in the 1st Amendment.

CELP's delivery did not begin until 1989 that CELP is pursuing a "catch up" in their contract. NWE emphasized that the contract year is not identified by the "base year" that is at column 2, LFE # 2 (see NWE 9/13/06 Reply Brief to CELP's Response Brief, pp. 5-6). In the same reply brief, NWE makes three arguments for using its allowed rate of return (ARR) in place of the marginal cost of capital: (1)the ARR is stable and non-controversial. In contrast, if the MCC is to be decided anew each year, it will be contentious; (2) the ARR is decided in a forum wherein experts debate the issues. The ARR also complies with the FERC's avoided cost requirement. Use of the ARR also conforms to the intent of Finding of Fact 34 and (3) since Finding of Fact 34 does not require the use of the ARR or the MCC, the PSC should apply the index that best insulates ratepayers and that keeps them indifferent as to a purchase from a QF rather than a built plant (see NWE 9/13/06 Reply Brief to CELP's Response Brief, pp. 7-8).

11. Bearer of Risk for Changed QFLT Rates:

CELP holds that NWE admits[10] that its shareholders bear the risk of QF nonperformance and that ratepayers are left indifferent given the stipulation entered into as part of D2001.1.5. Based on this SEC filing, NWE admits that its shareholders bear the risk of QF non-performance. It is implicit in NWE's statement, according to CELP, that QF performance currently benefits NWE shareholders as QFs provide power at relatively low prices during times of "high commodity" prices (CELP 8/15/06, Reply Brief on Interim Rates, p. 8-9).

CELP also held that NWE will receive a $662,623,824 benefit to compensate it for an increase in stranded costs that are above the "default supply rates." That is, the

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[10] CELP's belief that there was an admission appears to stem from the content of 10-Q that NWE filed with the SEC. That exhibit's (No. 2) relevant statements include in part: "Our obligation to supply minimum annual quantity of power to the Montana default supply could expose us to material commodity price risk if certain qualifying facilities (QFs) under contract with us do not supply during a time of high commodity prices as we are required to supply any quantity deficiency…Since we own no material generation in Montana, the anticipated source for any quantity deficiency is the wholesale market which, in turn, would subject us to commodity price volatility."

higher annual costs for escalating energy and capacity are a "bargain" that MPC made with CELP in March of 1988 (CELP 8/31/06 Response to NWE's Post-Hearing Brief, pp. 20).

12. Stranded Costs Owed to CELP:

CELP holds that given the 1st Amendment mandates an annual update compliant with D83.1.2, both MPC and NWE must have been aware of the "stranded costs" owed to CELP beginning with contract year 15 (that CELP asserts started July 1, 2004).[11] CELP adds that the 1st Amendment obviously required contract year 16 to use "…fully escalated values existing in 2004, or, for that matter, the millions of dollars they underpaid CELP in the first 15 contract years..," (CELP 8/15/06, Reply Brief on Interim Rates, p. 9).

NWE holds that there can be unintended consequences that will affect the ability of NWE to finance its operations that could impact ratepayer rates (NWE 8/18/06 Post-Hearing Brief, p. 5).

13. Interpretation of Orders 4865 and 5017:

In regard to how to interpret FOF 34 of Order 4865, and D83.1.2 orders, and in regard to tax effects, NWE states that CELP has never understood the fact that directive orders for an "initial" rate and subsequent annual compliance updates are not the same thing (NWE 8/18/06 Post Hearing Brief, p. 8).

CELP cites to Order 5017 (FOF No. 10) to then assert that there is a "logical absurdity" in a NWE position (presumably the one related to that just cited from the NWE 8/18/06 Brief). The cited FOF No 10, from D83.1.2 (Order 5017) is part of the PSC's explanation as to why long-term fixed rates are needed (CELP 8/31/06 Response to NWE's Post-Hearing Brief, pp. 12-13).

[11] There is an inconsistency in CELP's cross reference of contract years (e.g., 1, 2…16) and the associated time period. In its August 1, 2006 Opening Brief on Interim Rates (p. 6), CELP correlates contract year 16 with 2004-05. Thus, by implication contract year 15 would necessarily be 2003-04. In its August 31, 2006 Response to NWE's Post-Hearing Brief (p. 5) CELP again correlates contract year 16 with 2004-05.

IV. Discussion of Issues:

In the following discussion I organize and consolidate the issues for decision making into the following three categories: (1) rate and cost issues, (2) non-rate non-contract Issues and (3) contract issues. As there are relationships between certain categories of issues, it may be helpful to first work through all the issues before making decisions. Within each of the categories the issues are then listed. For each issue there is a "staff" discussion that may include a recommendation.

1. Rate and Cost Issues

i. The incremental cost of capital (ICC) with tax effects:

a. Should an ICC or the ARR (allowed rate of return) be used?

Staff: For discussion, the ICC should be used but the ARR may be a pragmatic option until the ICC can be properly deliberated; this is one reason for holding later that the issue needs to be properly deliberated.

b. Which ICC or which ARR should be used?

Staff: Of the two ICC values, NWE's would appear to have the greater likelihood of being accurate. CELP's ICC estimate of 10.65% appears high in comparison to NWE's of 8.143%. CELP's ICC estimate also appears high given that the ARR is 8.46% and that NWE's recent information filing that includes 9% as the weighted cost of capital. The current ARR could be used until the issue is properly deliberated (NWE states to not have a fresh ICC estimate). For background, the "marginal cost of capital" filed by MPC for QFLT rate making was 8.95% in D99.10.233 (I could not locate the year 2000 filing). In its 2001 filing, MPC included a "marginal cost of capital" of 8.464% (D 2001.7.100); however, this is the value that apparently is an ARR value. Although not entirely clear as to whether he was referencing the present ICC or the pre-2001 ICC, Stauffer testified that it may be appropriate to use the ICC in these calculations; the latest I found is the above 8.95% (TR 291, lines 20-23).

c. Adjust the ICC for tax effects for use with the annual carrying charge (ACC).

Staff: NWE already includes tax effects in the ACC (see also TR 307-308). Note that the ICCs that were used were not adjusted a second time for tax effects in MPC's 1983, 1984 and the 1985 QFLT compliance filings (I did not check subsequent year's compliance filings).

d. Frequency with which to compute the ICC or the ARR.

Staff: MPC made ICC estimates for QFLT rate calculations in each of 1983, 1984 and 1985 (I did not check subsequent years). In 2001, NWE apparently replaced the ICC with the ARR for purposes of computing the ACC, not the LFCF, a practice that has continued since 2001. If an ICC must be used, it may become, and probably should be, a contested issue so long as there remains a contract (CELP's) that requires the calculation of the escalating QFLT rate. In the alternative, whether an ARR is a reasonable proxy for the ICC, in the ACC, would appear to need more thorough deliberation.

e. When to begin using the ICC to compute the ACC.

Staff: This question presumes the ICC is chosen in place of the presently used ARR. There appears the following options: (1) the 2004/05 contract year that is the first (16^{th} year of CELP's contract) where in the "Fixed Energy Rate" ER_n is first computed using the ratio method that, in turn, involves plant costs that are adjusted by the cost of capital; (2) NWE's Stauffer suggests that if a change is made to begin using the ICC, that all three years of interim approved rates should be revised; and (3) a prospective year (e.g., 2006-07 or 2007-06) in which the ICC, vis-à-vis the ARR, may be thoroughly explored. I favor the latter option.

f. Should the levelized fixed charge factor (LFCF) be refreshed?

Staff: NWE asserts to have frozen the LFCF since 1988 (the LFCF embeds the effects of taxes, depreciation etc.,) and testified in favor of refreshing all inputs in the LFCF if an ICC is used. The LFCF is uniquely designed for specific types of plant (e.g., C 3 & 4). The PSC made abundantly clear in its D83.1.2 orders (5017 and 5017a, parts of which are attached) that a significant problem in encouraging QF development had been rate uncertainty (Order 5017, FOF 10). The PSC addressed the problem of rate uncertainty in D83.1.2, in part by requiring three rate options to be tariffed. In its D83.1.2 orders, the PSC required that the "Base Long-Term Rate" would be the rate basis for the fully escalating QFLT rate option (Order 5017, FOF 54) which is the rate option used, in part, in the amended CELP contract. The PSC clarified that with the QFLT escalating rate option that plant costs (for C 3 & 4 and for a peaking plant), the coal and the variable O&M costs would escalate (Order 5017a, FOF 17, 18). The PSC further clarified that the Base Long Term Rate shall continue to be computed with revised cost estimates until the PSC replaces the existing proxies for base load facilities with other base load facilities. That is, the PSC may choose to replace C 3 & 4 at a later date.[12] In turn, it would follow that the inputs into the LFCF may change if a new proxy for base load plant costs was used in the escalating rate option. The replacement would effect the escalating long-term rate option (Order 5017a, FOF 23, 24). Therefore, there appears at least one circumstance when the LFCF could be changed consistent with the PSC's D83.1.2 orders. Other circumstances would need further deliberation. Stauffer's recommendation to revise the LFCF if an ICC is used is not consistent with MPC's use of an ICC after 1988 and through 2001 when an ICC (marginal cost of capital) value ceased to be used. After 1988, the LFCF values were frozen.

ii. Escalation, the Unit Labor Cost (ULC):

Staff: CELP did not otherwise contest NWE's choice of inflation indices. NWE, however, recommends a PSC finding that approves of NWE's proposals for this and future QFLT filings (see 9/13/06 NWE Reply Brief to CELP's response Brief, p. 13). First, the mistaken use of 3 quarters of data should be corrected (to use 4 quarters).[13]

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[12] NWE held that only inflation adjustments are made to the escalating rates (TR 239-240).

[13] He estimates the magnitude of the ULC error for the escalating and partially levelized rates. As for rate corrections, he also explains how in D2002.7.80 interim rates were corrected, adding that on no occasion has a rate that was finally approved been corrected; the time-value-of-money reflects the WSJ's published Prime rate. DR PSC -121
As for errors and true ups to interim approved rates, he notes that NWE's September 28, 2005 submittal requested that the QFLT escalating and partially escalating rates for contract years 2004-5 and 2005-6 be corrected for known errors, adding that CELP Hanover Hydro and Pine Creek will all be impacted. DR PSC -126(a),(c)

Second, I would advise against an approval that would extend beyond the confines of this consolidated QF case.

iii. Include the coal severance tax:

Staff: NWE asserts to have included such taxes (see TR-226, NWE's proprietary data responses, CELP-005 and CELP-009).

2. Non-rate non-contract Issues

i. Whether to order NWE to update the 1998-2004 out-of-market cost estimate:

Staff: Ordering an update appears unnecessary. The amount by which the market value of QF power was understated and the out-of-market (stranded cost) estimates were exaggerated is not clearly relevant to the issues in these dockets (except perhaps in a contractual sense).[14]

ii. Whether there are ratepayer impacts:

Staff: Depending upon the PSC's other decisions, there may or there may not be (indirect) ratepayer impacts although the Montana Consumer Counsel appears to hold that ratepayers are fully protected (TR 64), a point on which NWE disagreed (TR 72).

iii. The relevance of Order 4865 and of Finding of Fact 34:

Staff: There is some confusion over the relevance of both the Order and of FOF 34. I would suggest clarification with specific application to CELP's D83.1.2 rate options. First, Order 4865 was foundational for D83.1.2 but the Order 4865 rate options were grandfathered when D83.1.2 was finalized. Clearly there was a continuance of many of the general principles in Order 4865 when D83.1.2 was finalized. But, it is, in the final analysis, the D83.1.2 rates that CELP selected.

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[14] Re: Final Order No 5986w in D97.7.90 on MPC's electric utility restructuring transition plan (also Order 6353c in D2001.1.5).

3. Contract Issues

i. Making CELP whole for prior year's underpayments:

Staff: As for the contract related aspect (1st Amendment, that is attached, and the alleged $57 million shortfall estimate if the contract was terminated), the PSC should not comment, other than to find that it is a contract matter (interim rate approvals should be finalized, and such changes may result in changed rates).

ii. Promptly assuming the contract:

Staff: This appears moot a moot issue, with a finding to that effect. [15]

iii. ICC and tax adjustments:

Staff: Whether changing the variable used in the ACC from an ICC to an ARR estimate is a material change that violates the contract is, in part, a legal question. There are both policy and technical aspects as well.

iv. Escalation Adjustment for Shorted Rates:

Staff: In short, this appears a strict contract issue. That said, if the PSC desires a recommendation, I would recommend rejection of the CELP proposal.

v. Whether use of the ARR and not the ICC violates the CELP/MPC contract:

Staff: This is a reference to Lauckhart's surrebuttal that appears to be a contract issue.

[15] By "promptly assumed," CELP means that the "Plan of Reorganization" must necessarily deal with the treatment of executory contracts and "Assumption simply means executory contracts in existence prior to the bankruptcy proceeding should continue after the reorganization of NWE as if the bankruptcy did not occur." (DR PSC - 027)

vi. How to make the 1st Amendment ratio approach operational and involving the separate (CELP alleged) impacts of not using the ICC and not adjusting the ICC for taxes:

Staff: This is a reference to the filed surrebuttal. Again, this issue appears, in part, contractual in nature. The non-contractual aspect involves any change in the inputs used to compute the rate CELP receives (e.g., ICC in place of the ARR beginning in 2001) pursuant to its 1st Amendment. I would note that although I have no record of whether a QF opted for the escalating QFLT option prior to its grandfathering, I assume there was not any such contract. Therefore, for the time period (roughly) 1986 up until the time MPC and CELP struck the 1st Amendment, MPC had no apparent reason or obligation to compute the escalating rate option. I would also note that CELP has asserted that only the interim rates can now be adjusted.